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Fred M. Oliver

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# Internal Control in Governmental Units

by FRED M. OLIVER  
Partner, Salt Lake City Office

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**I**NTERNAL CONTROL in governmental units is a subject that has received wide exposure among finance officers across the years, with principal emphasis on procedures to safeguard cash and other closely related assets of the municipality, large or small.

In the narrow sense, this is what internal control has come to mean to all of us. In its broader aspects, internal control has a deeper meaning and significance than I believe we attribute to it from day to day. I am firm in my belief that it can and should make a very significant contribution to the cause of better government. Achievement of this objective, in this year of 1962, is one of the great needs of our times.

While we must give consideration to these conventional aspects of internal control, with your permission I should like to devote major emphasis to those internal procedures that serve to promote operational efficiency and encourage adherence to sound administrative policies.

I hope, therefore, that you will share this approach with me while we lift our eyes above the horizon and take a searching look at the relation of effective internal control to the goal of more efficient government.

The most widely accepted definition of internal control is that promulgated by the Committee on Auditing Procedures of the American Institute of Certified Public Accountants as *the plan of organization and all of the coördinate methods and measures adopted within an organization to (1) safeguard its assets, (2) check the accuracy and reliability of its accounting data, (3) promote operational efficiency and (4) encourage adherence to prescribed managerial policies*. Although this definition was meant primarily to apply to business organizations, it relates equally well to governmental units.

Before we go further, let us analyze briefly what this definition means to your city or mine. The first two points deal exclusively with financial and accounting control; the second two deal with operations and administrative policies. Thus, these four steps, com-

prising a system of internal control, break up into two broad groups.

Before discussing the measures of internal control in these two groups as they would apply to governmental units, let us lay down a few broad principles to guide us:

- The basic plan of organization of a municipality or other unit should provide for appropriate segregation of duties and responsibilities. Here the basic principle is that no one person should be permitted to handle a transaction completely from beginning to end. There must be the intervention of some other person or persons who afford a cross-check. Without such a separation, the accounting records may be so manipulated as to make the detection of errors and fraud extremely difficult, if not impossible. Where circumstances will not permit such a division, other protective practices must be found.

- There should be a basic system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues, and expenditures. These are best expressed in the form of a sound accounting system and proper office procedures.

- Sound practices must be followed in performance of duties and functions by each person who is a part of the system of internal control.

- There must be available personnel whose abilities and qualifications are commensurate with their responsibilities, namely, individuals with ability and experience to carry out prescribed procedures in an efficient and economical manner.

- Finally, the size of the organization has a great deal to do with the absence or presence of internal control. For example, a very small town with only one office employee has no internal control at all. Two employees may afford some internal control and it may increase accordingly as greater size and added employees permit a further division of duties and responsibilities.

## FINANCIAL AND ACCOUNTING CONTROL

Now let us turn our attention to the four steps of internal control in the order in which we named them.

### SAFEGUARDING ASSETS

No matter whether a city is large or small, cash receipts and disbursements constitute one of the most important areas for con-

cern as to internal control. It is well, therefore, that we give at least passing attention thereto, for there is probably not a city official present who does not have some contact or concern with the handling of cash in his own community. The volume of these funds, together with their public nature, demands a high degree of control and safeguard.

Here are a few of the more common rules for handling cash.

### *Cash Receipts*

- Clearly fix the responsibility for handling cash.
- If receipts are prepared manually, use prenumbered receipt forms, with someone independent of the person receiving cash accounting for all numbers and comparing the receipt totals with the bank deposit.
- If cash registers are used, an independent person should compare the locked-in totals with bank deposits.
- Allow as few persons as possible to handle cash between its receipt and deposit.
- Incoming cash should not be commingled with other cash used for making disbursements or cashing checks.
- Persons handling cash should not keep the general books or the accounts-receivable records.
- Cash should be received only by authorized persons in the office. Persons outside the office should not be permitted to collect cash.
- Persons handling cash should not have access to securities or assets readily convertible into cash.
- Cash on hand during and after office hours should be kept in a safe or other protective device except for nominal amounts carried in the cash drawer or register.

### *Cash Disbursements*

- Use prenumbered check forms, accounting for all numbers. Spoiled checks should be voided and retained.
- Preferably, require two signatures on each check; do not permit checks to be signed in blank.
- If checks are signed mechanically, signature plates should be controlled.
- Checks should be accompanied by approved disbursement vouchers when presented for signature. The supporting documents should be canceled to prevent their reuse.

- Bank accounts should be reconciled by someone who does not receive cash, write checks, or sign them.

- Payroll checks should be delivered by some person other than the one who prepares them or upon whose records they are based.

- Establish petty cash funds for minor disbursements, requiring signed tickets that are reviewed by a separate person at time of reimbursement.

The record books are replete with illustrations where defalcations and other frauds have occurred because internal control was weak. Let me cite three illustrations where this occurred in my own state in the past few years.

- Under the procedures followed in the office of a City license assessor and collector, an application blank for an annual license was completed by each business firm and submitted to the license office or field collector, together with cash or a check for the amount of the license fee entered on the application. Field collections were delivered to the City license office and the cash or checks entered manually on a receipt form that was not prenumbered.

The collector himself succeeded in lowering the amounts of license fees entered on applications by certain business owners and removed cash of equal amounts from proceeds of field collections, applying checks from other business firms to cover fees on such applications. Depositing of cash with the City Treasurer was delayed while the manipulation was accomplished.

Obviously some basic rules relating to cash receipts were violated or this defalcation would not have occurred. A primary weakness lay in permitting cash to be received at points other than in the office, at which location an official receipt would have been issued immediately. Further, where manual receipts are used, they should be on prenumbered forms, with someone independent of the person receiving cash, accounting for all numbers and comparing receipt totals with bank deposits or, as in this case, with amounts remitted to the City Treasurer. Also, receipts were not deposited intact, either daily or at frequent intervals.

- In another instance, an employee in the office of a county clerk confessed to taking money by substituting checks for which no receipts were written for cash in the register on which receipts had been written. What was wrong? First, it should have been a rule to require that receipts be written on all items of cash; second, no

comparisons were made by an independent person between details of deposits and receipt copies.

• In a third situation, a deputy in a county recorder's office ran up a sizeable shortage before detection by delaying deposits from one to five weeks after the date of recorded receipts, even omitting deposits on certain receipts over a period of more than a year. In most instances the cash receipts were correctly recorded in the general fund cash book. The deputy, who received the cash, made the entries in the cash book and prepared the bank deposits. He also reconciled the bank account each month.

Here again was evidence of violation of simple rules of internal control, a lack of separation of duties and responsibilities. Receipts were not being deposited daily or at frequent intervals. No independent person was making the entries in the cash book or comparing receipt totals with bank deposits. The same person making bank deposits was reconciling the bank account.

### *Handling Other Types of Assets*

But what about other types of assets? It would seem just as important to establish safeguards over materials and supplies, inventories, and fixed assets as it is for cash. Our legislators and administrators usually try to satisfy themselves that no expenditures have been made for which there were no appropriations and that a particular expenditure is charged to the correct account. Many of them, however, do not seem to care what happens to the materials and supplies for which the expenditure was made.

Simple procedures for proper classification of unused materials and orderly arrangement in storage areas, properly fenced or housed, are seldom followed. Often the quantities in question justify the use of a perpetual inventory or other records for comparison with physical inventories at periodic intervals. But more often than not these precautions fail to be observed.

Control over fixed assets is frequently even weaker than over inventories. This too may be because legislators and administrators are more interested in seeing that no expenditures are made without proper appropriation than in following up to see that the fixed assets resulting from these expenditures are properly controlled.

Fixed asset records should be maintained, with a clear record being made of all land owned. Title evidences, such as deeds, abstracts or title certificates, should be clearly described in city records

and properly filed for ready reference. Adequate descriptions of buildings owned should be set forth on fixed-asset cards or in appropriate ledgers. Machinery and equipment, autos and trucks, and furniture or office equipment should be physically tagged and periodically checked to card or ledger records if adequate control is to be maintained.

#### CHECKING THE ACCURACY AND RELIABILITY OF ACCOUNTING DATA

The basis for control over accounting data lies first of all in a sound accounting system. A carefully prepared chart of accounts serves a far more useful purpose than providing a niche into which each transaction is to be dropped. It can facilitate the economical preparation of financial statements and reports. It can prevent errors in the accounting figures or disclose them. The size and scope of large governmental units today is such that in most cases administrators can no longer exercise personal supervision over the conduct of operations. It has become necessary, therefore, for them to depend on accounting data and reports. Inaccurate data can cause costly decisions; it is therefore an important job of the system of internal control to furnish reliable information on which administrators will base their decisions.

#### OPERATIONS AND ADMINISTRATIVE CONTROL

We now come to the second group of measures, that is, the third and fourth steps constituting an effective system of internal control. They are so closely related in their application to government that they should be discussed together. When considered in their broadest sense, I firmly believe the application of sound procedures of internal control designed to achieve these two objectives—that is, the promotion of operational efficiency and the encouragement of adherence to prescribed administrative policies—can make a most significant contribution to better government in any city.

What are some elements of a system of internal control that can help achieve these objectives for a municipality? There are several, which should be considered individually.

#### LEGAL PROVISIONS

Whether your city operates under general law or is a home-rule city, the kind of legal provisions governing your activities will in-

fluence greatly your city's operating efficiency. First, let me emphasize the necessity of complying with legal provisions. They have the primary purpose of protecting the cash and other resources of the city and of controlling its expenditures by use of budgets and other procedures.

It has been a recognized principle that whenever there is a conflict between sound financial administration and legal requirements, the latter must take precedence. This brings me to the point that much of the weakness of existing systems of internal control in governmental units, in terms of promoting operational efficiency and development of sound administrative policies, lies in faulty legal provisions with which city officials must live from day to day.

This is a broad area that has barely been touched by the hand of the fiscal expert. It would seem a safe assertion that governmental units throughout the country are operating under a mass of legal provisions primarily comprising obstacles and handicaps to good internal control in terms of these two basic objectives. The reason for this is that the laws generally have been on the statute books for a great many years, while the whole field of governmental accounting, finance, and fiscal controls has achieved its marked improvements and advances in comparatively recent years. Up to this point there has been little or no coördination between fiscal aims and statutory provisions. This will come only as laws are rewritten in the various states.

With this background in mind, I should like to develop for your consideration some constructive proposals for improved statutory provisions that it is believed would greatly enhance operational efficiency of our governmental units. These will be discussed in appropriate sequence.

1. The fiscal laws governing municipalities ought to be codified into a single statute, covering generally all of the fiscal requirements with which city officials must conform. The existence of a single statute will permit the separate publication and distribution of such fiscal laws to city officials for their ready reference and use. This can serve the very useful purpose of developing a much broader understanding of the statutes, particularly as the composition of municipal governing bodies changes through the election process.

2. Fiscal controls and requirements should be built into the statutes. These should include provisions relative to the kind of accounting system to be followed, the bases of accounting to be employed, the kinds of funds to be established, funds for which



budgets are required, and a clear outline of budgeting requirements. The last-mentioned should include the preparation, execution, and control of budgets, together with reporting requirements. These should all conform in every way to the most modern practices in governmental accounting and finance.

3. There ought to be included in the statutes some provisions designed to create a financial environment in which better fiscal management may prevail. Some of these special provisions would include the right to accumulate a surplus in a city's general fund. This is a very important consideration, as most state laws require cities to include in the following year's budget any current excess of revenues over expenditures. A city needs a surplus in its general fund primarily for three basic purposes:

- For working capital, namely, to provide cash with which to finance expenditures from the beginning of the budget year until its major revenues, such as property or sales taxes, are collected. In this way it becomes unnecessary to operate on borrowed funds for current operating purposes, which is a long-range waste of taxpayers' money.
- To provide a fund or reserve out of which to meet emergency expenditures.
- To cover unanticipated deficits in future budget years.

While cities, in terms of sound fiscal planning and economical government, should be permitted to accumulate a surplus in the general fund, they should also be subject to a ceiling on such surplus. In a fiscal procedures act adopted in my own state in 1961, there is a provision that limits the surplus accumulation to fifty per cent of estimated revenue from property and sales taxes in the budget year plus ten per cent of total actual revenue of the last completed fiscal year. The fifty per cent factor provides the working capital and the ten per cent factor covers emergencies and unanticipated deficits.

Any surplus accumulated in excess of these ceilings is required to be included in the general fund budget of the ensuing year and the property tax levy reduced accordingly. The balance in surplus is frozen for the three specified purposes and may not be appropriated or used for any other purpose.

Another special provision would include use of an all-purpose property tax levy. Statutes of many states still provide for multi-

purpose levies, which are incompatible with modern-day concepts of general fund accounting.

Still another special provision would include the legal right to make interfund loans, a measure designed to reduce outside borrowing by cities. This is a feature that can produce many economies in the cost of borrowed money. Not only is it possible to retain interest revenues from such borrowings within the municipality, but the control over repayment provided by interfund loans accelerates the retirement of debt and avoids the payment of costly premiums usually found under call provisions of bond issues. It also saves the expense of many bond elections, legal fees, fiscal fees, and printing of bonds, where the size of the project or limited term of repayment will permit the use of interfund loans.

It is not intended that interfund loans be a substitute for long-range bond issues. There are many city construction programs requiring that bonds be issued, for which repayment is scheduled over a long period of time. On the other hand, cities frequently have short-range projects limited in amount for which repayment can be scheduled over relatively short periods. For this purpose interfund loans can be used to accomplish very substantial savings; legal authorization of such funds is considered to contribute substantially to operating efficiency, as money saved thereby is available for other lawful municipal purposes.

A further special provision would include the legal right to purchase with the surplus money of any fund or otherwise to acquire for investment or retirement, the issued, unmatured bonds of the city or any fund thereof.

This is a provision permitting the retirement of municipal debt to be greatly accelerated. With the change in money markets in recent years, the yields on municipal bonds have fluctuated greatly. The prices of many city bonds have on occasion dropped well below par, making it possible for cities to buy in their securities at substantial discounts in the open market. In many instances the fund that owes the bonded debt does not have the cash resources with which to retire the debt. But the legal authorization to purchase a city's own bonds for investment may permit another city fund to accomplish the interest saving and discount, the benefit of which will inure to the city as a whole.

I believe it can be readily seen how a set of legal provisions that encompass the most modern practices in governmental account-

ing and finance truly promotes operational efficiency and encourages sound administrative policies. In this way, internal control procedures, written into the laws that govern the fiscal operations of cities, can serve immeasurably to reduce the long-range cost of local government.

#### PRACTICAL OPERATING PROCEDURES

One of the great needs in local government today is expenditure control. Let me point out just a few statistics to demonstrate the importance of this statement.

For the decade 1950 to 1960 there were percentage increases in the following areas reflecting the basic growth pattern in the United States:

U. S. population, 19%  
Gross national product, 31%  
Total personal income, 73%

Contrast these basic statistics with the percentages of increase in expenditure for federal, state, and local governments:

1. The federal budget almost doubled in this past decade, rising from about \$39 billion to almost \$78 billion; per capital expenditure increased about 70 per cent.

2. With the public focus on the federal budget, with all of its emphasis on defense and international problems, few persons have noticed that state and local governments combined actually outstripped their political parent in rate of expenditure increase; they climbed by 105 per cent in the past ten years, with per capita expenditures rising 72 per cent.

These facts would seem to substantiate clearly the statement that one of the great needs in local government today is expenditure control.

Upon analysis we find there are just two kinds of basic expenditures: for salaries and wages of personnel and for materials, supplies, and services or other charges to outsiders. If we may assume that your city would have available to it, statutes containing fiscal provisions such as those just described, what practical operating procedures may be suggested to afford better internal control over expenditures for these kinds of items? I offer the following suggestions for your consideration.

## SOUND ADMINISTRATIVE PROGRAMS AND POLICIES

Essential elements of these would include:

- a) A centralized budgeting procedure, administered by experienced personnel;
- b) A centralized purchasing program;
- c) A sound personnel policy, comprised of:
  - Competent personnel, selected and promoted on basis of merit;
  - Effective supervision by well-trained key personnel;
  - Performance standards for employees, by which their efficiency and out-put can be measured;
  - Utilization of morale-building factors, such as competitive salaries, satisfactory working conditions and a reasonable prospect of retirement benefits;
- d) A program of administrative audit, including the conduct of management improvement studies;
- e) A carefully designed internal audit program, effectively correlated with the program of independent audit.

Let us examine a suggested plan of organization and internal procedures to assure adherence to such administrative policies and achieve effective control of expenditures.

### A BASIC PLAN OF ORGANIZATION

Assuming this would apply to a city of at least medium size, such a plan would centralize administration of all fiscal, accounting, and finance matters of a ministerial nature in a single appointive official, whose qualifications and experience requirements should be set at a high level. His title would appropriately be that of Director of Finance or in a small community it might be the city manager or other appropriate official.

Such official would serve directly (depending again on the size of the city) as the budget officer and be responsible for preparation, execution, and control of annual budgets. Directly under his supervision and closely related to budget activity would be:

- a) Purchasing and control over other cash outlays;
- b) Placement of personnel and development of performance standards therefor;

- c) Performance of administrative audits, with continuing execution of management improvement studies.

#### THE BUDGET PROCESS

a) In preparation of the budget, requests for funds would be related to actual *need* rather than the current and prior years' expenditures, as is the almost universal practice. This would be achieved primarily by basing requests as far as possible on *performance data*; in some instances, full-scale performance budgeting may be introduced. Performance data are properly described as the number of *work units* performed by personnel or groups of personnel in each sub-department of a city.

This type of approach is based on the fundamental premise that *a budget is a work program with a \$ on it*; that it should be based on work to be accomplished and services to be performed in a community, not merely the number of dollars currently or previously spent for such work or services.

b) The basic philosophy underlying perhaps a new approach to execution and control of budgets would utilize the principle of discretionary control, as based on demonstrated need, regardless of the amount of money available in an individual budget. The mechanics of achieving this objective would embrace the following:

##### Control over purchasing—

Under a program of centralized purchasing under direction of the budget officer, requisitions for materials and supplies would be subject to review on the basis of *need* and unsupported requests denied. This approach would offer a very effective brake on a common evil in city budgeting, the disposition of department heads near the end of each fiscal year to disburse unexpended appropriations as defense against a reduction in the budget of the ensuing year. It also offers an excellent means of disciplining department heads automatically to restrict buying to necessary and useful goods and services throughout the year.

##### Control over addition of new personnel—

Requests for new personnel to be employed would necessitate the approval of the budget officer and would be

required to be justified by the department making the request, using as the basis therefor the number of new *work units* to be performed. The selection of actual personnel to fill positions so approved would rest with the individual departments.

Personnel transfers and salary changes, while originated by department heads, would pass through the budget office before being submitted to the governing body for approval.

Control over utilization of existing personnel—

This may be achieved by utilization of a procedure best described as an *administrative* audit. Such a program implies a continuing study of the effectiveness and efficiency of personnel employed in each department or sub-department of a city, supplemented by management improvement studies in appropriate areas. Examples would be inauguration of programs for work simplification, mechanization, development of standard practices, and cultivation of work habits that help to regulate the flow of work and point it in the right direction. Such surveys lay the foundation for development of performance standards for employees, a broad step in curing one of the most baneful evils in governmental administration today—that of labor waste. One of the most obvious evidences of this is seen in the frequent situation of four persons doing the work of three, a not uncommon circumstance at all levels of government as we know it today.

## CONCLUSION

Let me sum up my remarks in this way: No one will deny the importance of internal control in the day-to-day conduct of governmental affairs; nor shall we fail to recognize the excellent progress in governmental units generally in the development of internal procedures to safeguard municipal resources and to enhance the reliability of accounting data through better accounting systems and improved financial reporting.

But I do not believe we can claim more than modest progress in the development and use of internal procedures that will encourage and promote operational efficiency and adherence to high administra-

tive standards. In fact, in my humble judgment at least, here is an almost untouched field offering many promising opportunities to contribute notably to the cause of better government everywhere.

It offers a very broad challenge to elected officials, to finance officers and even to the citizenry of our thousands of municipalities throughout the country. But more than with other groups, I believe the task must rest with the finance officers, persons with experience and training in the accounting and finance fields, to initiate the legal and fiscal reform urgently needed if the foundations are to be laid for higher levels of operating efficiency and upgraded administrative standards in our communities.

Both the challenge and opportunity are here. I hope that in the next decade we shall see great strides taken in this very important area of internal control in governmental units on a very broad scale.

